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DIRECTORATE OF
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Intelligence Memorandum

Hungary: The First Test of the New Economic Mechanism

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
May 1972

INTELLIGENCE MEMORANDUM

HUNGARY: THE FIRST TEST OF THE NEW ECONOMIC MECHANISM

Summary and Conclusions

1. Latent weaknesses in Hungary's four-year-old New Economic Mechanism (NEM) became costly for the first time in 1971. Runaway investment and a record trade deficit showed that the economic controls built into the decentralized economy were not enough to keep it stable. These developments stimulated internal debate within the regime and aroused Soviet concern. The leadership responded belatedly in the fall of 1971 with direct administrative action to curb investment, cut imports, and expand exports. The measures taken probably will put the economy back on course although difficult navigation lies ahead, especially in correcting the balance of trade with the West. However, the leadership, while reaffirming its faith in the NEM, has accepted the need for more vigorous central supervision of enterprise behavior.

2. The difficulties in 1971 arose in large part from the growing readiness of enterprises to use the increased freedom to invest given them in 1968. The warning signs were already visible in 1970, when investment spending rose 18%. The planners looked for a cutback in new investment starts in 1971, projecting only a 2% rise in total expenditures. But enterprises forged ahead with new projects, often without the required financial backing, and ministries and banks failed to stem the flood of applications for additional funds. As a result, investment spending continued far above plan through the third quarter, and even though direct controls were finally imposed in the fall, investment rose by 11% for the year as a whole.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

3. The investment boom in 1971 led to serious dislocations in the economy and a foreign trade deficit of US $490 million. Of this, some $240 million was in trade with the Communist countries, and about $250 million in trade with the West. Imports from both areas increased much more than planned. At the same time, earnings from exports to the West fell by 2% as a result of the economic slowdown in Western Europe. Many Hungarian officials had come to attribute export successes in 1969-70 as much to the NEM as to the boom in Western Europe and an exceptional harvest in 1969. They were evidently unprepared for such a slump when the boom ended in 1971.

4. These rapidly growing trade deficits triggered internal debate and Soviet pressure, which together forced the leadership to take action in late 1971. The regime postponed several state-financed projects and reestablished central supervision over enterprise investment. Financing requirements for enterprise investment were tightened drastically. In addition, quotas for imports of many Western goods were cut back and tariffs on imports and subsidies on exports were raised. Even so, Hungarian plans implied continued trade deficits in 1972 and apparently did not satisfy the USSR. After an emergency visit of Kadar to Moscow in February, the Hungarians agreed to increase exports to the countries of the Council for Mutual Economic Assistance (CEMA) by enough to provide for a small surplus in 1972. As a result, changes may have to be made either in Hungary's targets for growth or in those for trade with the West.

5. In the meantime, the government's stabilization program had an immediate impact – in the last quarter, investment slowed to a 1% annual growth rate and exports rebounded. Gains in exports continued in the first quarter of 1972 and imports dropped by 8%. Although these results, plus the new trade protocol, should blunt current Soviet criticism, the experience has left some disturbing long-run questions for the NEM. The economy is still very vulnerable to Western trade cycles, and investment decisions require close central control. At least in the near term, further decentralization seems remote.

Discussion

Investment and the New Economic Mechanism

6. After smooth development in 1968-69, the Hungarian economy accelerated in 1970-71. By September 1971, investment was rising at an annual rate of 21%, coming on the heels of an 18% jump in 1970. Backlogs were piling up at a record rate; the stock of unfinished investment – some

75 billion forints in September 1971 – was nearly equal to the entire investment outlay in 1970. Industrial production was growing by only 5%, hardly much of a response to the heavy investment of the last year and a half (see the table). Prices of both capital goods and building materials – even though tightly controlled – were increasing at an annual rate of 3%-4%.

7. In addition to its impact on the domestic economy, the investment spree led to sharp increases in imports of raw materials, semi-finished goods, and machinery, especially from the West. Between 1969 and 1971, imports from the West of raw materials and semi-finished goods rose 46%, and of machinery, equipment, and spare parts, 90%. These purchases, together with rising imports of consumer goods, pushed total imports from the West from $622 million in 1969 to over $1 billion in 1971 – a 65% increase. Imports from the Communist area, chiefly of the same goods, rose 50% during 1970-71.

8. Excessive investment is not unfamiliar to the Hungarians. In the years before the NEM was adopted, ministries competing for investment funds repeatedly understated the costs of carrying out favorite projects, a tendency that central planners seemed powerless to control. Too many projects were started, putting constant strain on the supply of materials and stretching out lead times between project design and completion. Moreover, investment decisions aggravated imbalances in the economy. Planners favored sectors such as steel and chemicals, which required large imports of machinery and material inputs, and they neglected construction and the building materials industry, where expansion was urgently needed to support even the planned increase in investment.

9. Hungary, in fact, has invested proportionately the least in the construction industry among CEMA countries. Construction workers in Hungary represent 6% of the work force, compared with 7%-8% in other East European states. As a result, according to a Hungarian economist, in both capacity and level of technology in the construction industry, Hungary compares unfavorably with other East European countries (except Bulgaria).

10. The backward building materials industry has added to the troubles in construction. Total output of building materials rose by only 26% between 1965 and 1970, whereas construction work grew 65%. The building materials industry is one of the most out of date, planners have given it one of the lowest priorities, and projects to increase production have been drawn out longer or postponed more often than other projects. For instance, the decision to build the Beremend cement factory dragged on for three years while it was argued whether the plant was necessary. Then an additional year was taken merely to sign the contract to begin construction. The plant still is not finished, and the Hungarians have been forced to import Western cement.

Hungary: Investment, Output, and Trade

	1968	1969	1970	1971
	Percent Change over the Previous Year			
Investment in fixed assets	2	8	18	11
Industrial output	5	2	7	5
Trade with the West				
Imports from the West	-4	9	43	16
Of which:				
Raw materials and semi-finished goods	6	7	34	9
Machinery and equipment	-27	17	28	49
Exports to the West	-6	32	20	-2
	Million US $			
Trade Balance	-64	+44	-91	-249
	Percent Change over the Previous Year			
Trade with Communist countries				
Imports from the Communist countries	4	6	24	21
Of which:				
Raw materials and semi-finished goods	12	4	15	16
Machinery and equipment	-11	6	43	38
Exports to the Communist countries	10	10	7	13
	Million US $			
Trade Balance	+51	+112	-98	-240

11. Under the NEM, the Hungarians hoped to cope with the investment problems by modernizing the construction and building materials industries and by decentralizing investment decision making.(1) Beginning in 1969, substantial funds were earmarked for expanding output of cement, bricks, and other materials, and the construction industry was given a larger share of investment. Little payoff has been achieved so far or, in fact, was expected by the leadership in the short run.

12. A more immediate impact came from decentralization but in the direction opposite to that expected. Enterprises and state banks were given significant investment authority at the expense of the often politically motivated ministries. In theory, only firms that were profitable would be able to invest. The profits of an enterprise were to be divided into a profit sharing fund, a reserve fund, and a development fund. Development funds – the source of an enterprise's own investment – could be either invested or placed on deposit with the banks to earn interest, although interest rates are too low to offer an attractive alternative to investment. Enterprise funds also could be supplemented by state credits or grants or by bank credit. Bank and state credit would be parceled out according to three criteria: the size of the development fund of the enterprise applying for credit; the expected profitability of the project; and, for large projects, the contribution of the intended investment to national economic objectives. Under the new system, nearly all investment would be initiated by enterprises.

13. The reformers' expectations were not realized. The now relatively unfettered enterprises refused to play by the new rules. Even while the NEM was being devised, enterprises deliberately underreported their profit position in the hope of retaining more profits or obtaining higher subsidies. As a result, enterprise profits in the early stages of the reform were 50% larger than the government had expected. Development funds and self-initiated investment swelled excessively. Above-plan investment by enterprises amounted to 3.2 billion forints in 1969, and rose to 10 billion forints in 1971. The inflationary rise in investment put considerable pressure on prices of building materials, which, although heavily controlled, still increased by 4% in 1971.

14. Excess investment was also encouraged by state subsidies on which the government continued to rely to prevent unemployment, large price increases, a reduced standard of living, and any other obstacle to the smooth introduction of the reform. As the Hungarians came to realize, the transition probably was too smooth; the subsidies preserved most of Hungary's

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unprofitable activities, and, in fact, left nearly all enterprises with some funds to invest. Indeed, many unprofitable enterprises had as much or even more to invest than the profitable firms.

15. As might be expected, enterprises frequently initiated projects without the required financial backing. For example, the Tisza chemical combine began a $25 million development program in 1971 with financial backing for about one-half of its program. The coal mining enterprises in Borsod placed orders for various installations even though their application for credit had not been finally approved. According to Deputy Premier Matyas Timar, the "motto" of enterprises was, "What is important is to get the work going; the state will give the missing money from its budget." A government audit in 1970 discovered that 32 enterprises did not have development funds to cover 3 billion forints in committed investment; the state financed about 70% of the difference, creating a substantial budget deficit. Meanwhile, the banks, which had been expected to play a major role in rationing investment, were simply sidestepped by enterprises.

16. Even the major projects that remained in state hands were too numerous and not effectively controlled. The responsibility for various stages of these projects – from blueprint to construction – was scattered among enterprises and ministries, leading to breakdowns in coordination and cost overruns. The Ministry of Finance and the National Planning Office, which had been expected to coordinate and control major investments, had neither adequate information about nor effective veto over the projects being promoted by other ministries.

17. Senior officials were aware of these investment problems and did attempt some remedial action early in 1971. The planners scheduled a mere 2% rise in investment for the year, and measures were passed in January 1971 to restrict new starts. But they were not enforced and the growth of investment continued to accelerate. The Hungarians might have acted more decisively, had it not been for an unwarranted optimism regarding exports. The NEM was receiving undeserved credit for the boom in exports to the West.

Exports: A Rare Case of Euphoria

18. Hungary was for many years extremely careful of its trade balance with the West, having learned a lesson in 1957, when it was forced to take Soviet assistance, and advice. In 1969-70, however, the Hungarians dropped their guard, overreacting to favorable market and price developments in Western Europe, and overestimating the role of the NEM in improving Hungary's export position.

19. The Western boom in 1969 and 1970 indeed boosted Hungary's export fortunes. Raw and semi-finished materials, food, and even machinery exports to the West grew rapidly. Overall, exports to the West soared 58% in 1969-70, and in 1969 the Hungarians recorded an historic surplus with the West of $44 million (see the table).

20. The Hungarians were not only selling more to the West but at higher prices. While export prices to the Communist countries remained nearly constant in 1969 and 1970, export prices to the West were rapidly increasing. In 1969, prices received for exports to the West went up by 7%, and in 1970, by an additional 9%.

21. The usual prudence of the Hungarians gave way to euphoria, and they began to attribute the export gains more and more to the economic reform and less and less to the Western boom, although the planned increase in exports for 1971 – only 5% – was much less than the actual increase in 1969-70. A few sober voices correctly diagnosed the situation, but they were increasingly drowned out by more exuberant officials. Even Jozsef Bognar, usually one of Hungary's most realistic economists, credited the reform with export success: "[it] proves the validity of the new methods of export incentives and organization." In 1970, Minister of Foreign Trade Jozsef Biro attributed export gains to the NEM and its "marketing improvements of Hungarian enterprises." The Hungarians became so confident that they reduced export subsidies so that sales to the West would not rise so fast as to disturb domestic supply. At the same time, they permitted imports of consumer goods from the West nearly to triple during 1969-70 – in part, to extend some of the benefits of the export boom to the population.

1971 -- A Widening Trade Gap

22. In 1971 the roof fell in. The downturn in Western Europe shrank the market for Hungarian raw materials and machinery and, to a lesser extent, food. Exports of raw materials and semi-finished goods dropped 11% from the 1970 level, while machinery sales dropped 2%. Exports of food and consumer goods did increase in 1971, but not enough to offset declines in other areas. Despite an improvement in the last quarter of 1971, the Hungarians ended the year with a 2% decline in exports to the West. The largest declines – up to 12% – were in exports to France, West Germany, Austria, and the United Kingdom. Export prices, which in 1969-70 had served to magnify increased Hungarian earnings, rose by only 1% in 1971.

23. The continued lag in exports to the West became more and more serious, given the rapid climb in imports. By the end of the third quarter

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of 1971, the trade deficit with the West of $270 million was more than double the previous annual record set in 1964 and, more striking, was equal to the cumulative trade deficit for the entire 1965-70 period. In spite of some increase in net earnings on invisibles, the current account deficit was running at an annual rate of $200 million in 1971, raising the cumulative current deficit since the late 1950s to about $600 million.(2) Available data are too fragmentary to permit an independent estimate of the capital account, but the above figures suggest that outstanding indebtedness grew by about one-half in the first three quarters in 1971 to at least $500 million, or two-thirds of the annual value of current exports to the West.

24. As might be expected, investment excesses had a similar impact on trade with the Communist countries, requiring huge increases in imports of raw and semi-finished materials and machinery and equipment. In contrast to exports to the West, shipments to the Communist countries rose by 10% in the first three quarters of 1971, close to the 11% planned. At the same time, however, imports from the Communist countries were rising 25%, compared with the 10% planned,(3) resulting in a deficit on clearing account of $285 million, 60% of which was shouldered by the Soviet Union. This brought the total trade gap to $555 million for the first three quarters of 1971. With the trade deficit (as well as investment) reaching the danger point, the regime could no longer avoid taking drastic action.

The Leadership Reacts

25. Through the summer of 1971, the government's outward reaction to the obvious and growing difficulties amounted to rather bland calls for more responsibility in investment decisions and fairly routine descriptions of investment and trade troubles. Of course, more concrete efforts to curb investment may have been going on behind the scenes. Nevertheless, it was not until fall, and specifically until a dramatic speech by Premier Jeno Fock in October 1971, that the government unleashed an all-out attack.

26. To Fock, investments were "the root...of all negative phenomena" in the domestic economy and in the balance of payments. He blamed enterprises for investing beyond their means, the ministries for failing to prevent ill-financed projects, and planners for underestimating development costs and overestimating resources available for new investment. Fock

2. The cumulative current account deficit is estimated at $360 million for 1959-69. The deficit in 1970 was roughly $40 million. The greater part of the current account deficit has been financed by Western bank loans and by supplier credits.
3. It would appear that the Hungarians must have received special concessions from the USSR in order to manage such an increase in imports over plan.

revived the lines of authority, announcing that the "fullest responsibility" would be granted to the National Planning Office for working out the major proportions of investment resources and the future scheduling of central investment objectives. Working closely with the planners, the Ministry of Finance and the banks were to coordinate and control the financing of investment, and the Ministry of Construction and Urban Development would harmonize construction activity. According to Fock, the government would no longer automatically finance cost overruns.

27. Following Fock's address, the government announced the objective of curbing the increase in investment and the trade deficit in the last two months of 1971 and holding investment in 1972 near the expected 1971 level.(4) In support of this goal the government introduced a system of sanctions on any enterprises and ministries undertaking investment uncovered by required funds, imposed higher default fees paid to banks, put a freeze on investment by firms in financial trouble, and adopted a number of restrictions on investment in certain sectors and kinds of projects.

28. Investment in 1972 was to be concentrated mainly on completing unfinished construction. Of the eight major government projects originally scheduled for 1972, only five were now slated, and funds were to be shifted to projects already under way. In effect, new investment in 1972 was being restricted to specified sectors, such as vehicles, textiles, and computers, which have the government's stamp of approval.

29. For the enterprises, investment was expected to decline by about 2 billion forints in 1972, and their share of total investment was to drop from 57% in 1971 to 55%, a drop of about 4%. A ban was placed on beginning certain "luxury" projects, such as recreation centers, office buildings, and enterprise headquarters through June 1972. Bank credit was to be carefully rationed through 1972. Enterprises were further restricted by a regulation requiring the establishment of a reserve fund equal to 20% of the construction costs of an investment.

30. These measures were expected to reduce demand for imports and release more domestic goods for export. In addition, more import goods were placed under quota, export quotas were liberalized, and the state budget for 1972 was to allocate 10% less for price subsidies for imports and 7% more for exports than in 1971. The government also decreed a reduction of 20%-25% in imports of Western consumer goods in 1972 compared with 1971.

4. As late as December 1971, the Hungarians expected that investment would reach 106 billion forints in 1971, and the 1972 plan projected the same level for 1972. However, the controls successfully stemmed investment in 1971 to a year-end total of 100 billion forints and the 1972 plan, therefore, represents a 6% increase over 1971.

31. The Hungarians planned to increase domestic production of building materials and to shift imports to the socialist countries. They decided to accelerate the construction of the Beremend cement plant, establish new tile plants in Budapest, and increase output of cement pipes and building ceramics, all of which measures were designed to reduce imports. At the same time, increased Soviet deliveries of asbestos-cement products were expected to replace imports from the West. The Bulgarians were to provide alkali carbonate for glass manufacture formerly purchased from the West, and Romania and Poland were to supply the natural gypsum requirements of Hungarian cement production.

32. Finally a number of price boosts were instituted for 1972 with the multiple purposes of stimulating domestic production, reducing imports, and lowering budget subsidies. Most of these increases were for building materials. Prices of bricks and tile were increased 32% and cement about 10%. Iron and steel prices were raised 15%, with premium bonuses for high quality. Copper and aluminum prices went up by 10%, and prices of basic synthetic products by 14%.

33. Despite the broad scope of the measures, they were intended to bring about a slowdown but not a severe retrenchment. The Chairman of the National Planning Office, Imre Pardi, asked, "whether we want to solve the balance problems gradually within the framework of continuous development or within a short time, even at the expense of a temporary halt in development." Pardi chose the former, as did Politburo member Nyers, who argued that "hasty cutbacks are meaningless" and that the correct program should be gradual and evenhanded. As a result, the regime announced the goal of cutting 1%-2% annually from the rate of growth for several years rather than attempting to shock the economy into equilibrium.

34. This gradual approach was most evident in proposed Hungarian foreign trade plans announced in December. The plans implied smaller but still sizable deficits in 1972 with both the West ($200 million) and the Communist countries ($127 million). According to the Hungarians, "a more radical cut in imports would do more harm than good" because it would hamstring development plans as well as reduce inputs for current production. They had trouble, however, selling their policy to the USSR.

The Soviet Shadow

35. The performance of the Hungarian economy in 1971 had heightened Soviet suspicion of the NEM and cooled the already lukewarm support extended by the USSR during 1968-70. By late 1971 a Hungarian ministry official admitted that the USSR was unhappy with the loose

economic controls which it felt were responsible for the economic problems in 1971. An article in **Pravda** (3 December 1971) catalogued the ills of the Hungarian economy and, in a backhanded slap at Hungarian decentralization, suggested that the problem could only be solved by the "leading organs," probably meaning the ministries as well as the party. "Their job," according to the article, was to "ensure the observance of national economic interests and the planned development of the economy" and to "regulate the movement of goods and prices."

36. Soviet displeasure evidently continued, for on 11 February, Communist Party Chief Janos Kadar flew to Moscow for an "unofficial, friendly visit." In addition to Soviet dissatisfaction, Kadar apparently was facing opposition at home. [redacted] prominent 25X1
Hungarian conservatives had begun to argue against the NEM, seizing on the economic difficulties and Soviet discontent as ammunition. [redacted] 25X1
In order to counter the conservatives, Kadar took the initiative of flying to Moscow, where he was apparently able to gain at least temporary Soviet support.

37. Part of the price was a revision of trade plans with the USSR. After a 1971 trade surplus of $140 million with Hungary, the USSR was unwilling to permit another one.(5) Trade plans, which had been published in January 1972, were revised by March-April and revealed a new commitment by the Hungarians to a small 1972 surplus with both the Soviet Union and the CEMA countries. The change involves a shift of $157 million in the projected balance for Hungarian trade for 1972 with the Communist countries from a deficit of $127 million to a surplus of $30 million.(6)

38. With these changes in 1972 trade, Kadar probably was able to placate the USSR, although Soviet annoyance evidently persisted, as admitted by Fock on returning in March from a follow-up trip to Moscow to discuss "pressing" questions of trade and economic development. In his favor, Kadar could point to early positive results from the control measures. The annual rate of increase in investment fell from 21% in the first three quarters of 1971 to only a 1% rise in the final quarter, resulting in an 11% increase for the year as a whole. Moreover, the Hungarians managed to run a surplus in trade with the West and the Communist countries in the last quarter, paced by large increases in exports of food and raw

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5. There may have been adjustments made in trade plans with other Communist countries, but the major shift was clearly with the Soviet Union.
6. A further expansion of Soviet-Hungarian trade in 1972 was announced by trade Minister Biro in Moscow on 28-29 April and additional meetings are scheduled for May and July, but no specifics have been announced.

materials to the West and machinery and raw materials to the Communist countries. Imports from the West also slowed down in the last quarter with the exception of agricultural imports, largely of high protein feed.

Prospects

39. The additional measures enacted for 1972 should bring continued improvement. Investment probably can be held near the planned level; demand for investment goods and construction materials should ease; and moreover, domestic output and Soviet and East European deliveries of building materials should help to satisfy that demand. The first-quarter trade results for 1972 continued the favorable trend of the previous quarter, with exports increasing at an annual rate of 26% and imports declining by 8%.

40. It is not clear, however, whether Hungary will be able to maintain growth and keep the deficit with the West to the planned level, given the new trade demands by the USSR. One favorable factor is that the USSR will still deliver 7%-8% more raw and semi-finished materials in 1972 and instead make reductions in machinery and equipment deliveries compatible with the Hungarian slowdown in investment in 1972. Nevertheless, the Hungarians had admitted even before the trade revision that the export plan with the West would be extremely difficult to achieve. It seems likely that either the foreign trade balance planned with the West or domestic growth plans will have to be adjusted.

41. An additional constraint on growth and trade is the desire by the leadership to retain popular support for the NEM. As Nyers promised in an address to the National Assembly in December, "the working masses do not have to tighten their belts, despite the difficulties." Thus the Hungarians still plan to import consumer goods from the Communist countries at a rate "above the average import level."

42. Another potential constraint is the still unsettled agricultural situation. An extended drought has already caused some damage to winter sown crops. Although recent rains have temporarily improved prospects for spring crops, any further dry spells will reduce harvests and consequently derail Hungarian schedules for exports – and possibly imports – of agricultural products.

43. Despite the problems, the Hungarians seem to be taking the economic difficulties in stride and publicly refuse to be deflected from the basic course of the NEM. The measures enacted almost all involve adjustments, not basic changes, in the NEM. Many officials have also stressed the temporary nature of the measures and the ability of the NEM to handle the problems better than the old system. The Chairman of the National

Planning Office, Imre Pardi, has announced that enterprises will retain authority: "the 1972 measures do not alter in principle...the competence of the State or the competence of the enterprise."

44. Nevertheless, the experience has left some lessons for the leadership. First, the NEM has not changed Hungary's position as a marginal supplier in the Western market; the country is as vulnerable as ever to shifts in demand and prices in the West. Second, the NEM has not automatically made cost-conscious entrepreneurs out of Hungarian enterprise managers; tight strings are still needed on the investment process. The need to reduce subsidies and close out some unprofitable activities has also been reconfirmed.

45. The crisis in 1971 should have shown Kadar that he will have to continue to tread carefully until the economy rights itself again. At least in the near term, he is in no position to undertake further economic decentralization. Moreover, the new administrative controls on investment -- despite the regime's assurances that they are "temporary" -- might easily become permanent fixtures, amounting to recentralization. But if these measures actually are temporary, the regime still has done nothing to the NEM to keep the same problems from recurring.